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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 894

EDWARD H. WEITZEN, ET AL., PETITIONERS

v.

CHARLES HEIT, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION

This memorandum is submitted in response to the Court's order of February 24, 1969, inviting the Solicitor General to express the views of the United States. We believe that the decision of the court of appeals was correct and that the petition for a writ of certiorari should be denied.

STATEMENT

The petition arises out of three private actions brought under the federal securities laws against petitioners and two of the respondents. The complaints in the three actions allege, among other things, violations of Section 10(b) of the Securities Exchange

Act of 1934, 15 U.S.C. 78j(b), and the Commission's Rule 10b–5 thereunder, 17 CFR 240.10–5.[1] The complaints in all three actions (two of which had been consolidated) were dismissed in the district court for failure to state a claim upon which relief could be granted (Pet. App. 1b–15b, 1c–3c). The court of appeals reversed the district court decisions and remanded the cases for further proceedings (Pet. App. 1a–16a).

The pertinent allegations of the complaints, which "are substantially the same" (Pet. 7–8), are as follows.[2] Defendant Belock Instrument Corporation ("Belock") is a publicly-owned corporation engaged principally in the manufacture and sale of precision and other instruments and components (16a; 68a, 70a). Its common stock and debentures are listed on the American Stock Exchange (16a; 70a). The other defendants are or were officers, directors, controlling shareholders or auditors of the corporation (16a; 68a–70a). Belock derived over 90 percent of its sales from government contracts, which included price redetermination clauses providing for separate review of the amounts paid under each contract (70a). In setting forth the results of this business for the period November 1, 1963, to January 31, 1965, Belock substan-

[1] Section 10(b) and Rule 10b–5 are set out at pages 4–5 of the petition. Since the petition does not raise any question about any of the other provisions involved in the litigation below, we shall not deal with them here.

[2] The complaints are set forth in the appendix to the brief of the plaintiffs-appellants in the court of appeals, which is cited in this memorandum as "—a." The appendix to the petition for a writ of certiorari is cited herein as "Pet App. —."

tially overstated its net assets and past and prospective income by including earnings, income and assets resulting from substantial overcharges to the United States Government (17a; 70a–72a). All the defendants knew that this financial information was false (18a; 72a).[3] They "caused [the false information] to be circulated and disseminated to the public-at-large through press releases, statements to the investment community, quarterly and other financial reports and through other media of communication to the public * * *;" it was also included in reports filed with the Commission and the American Stock Exchange (17a; 71a). The dissemination of the press releases, statements and reports "was intended to, and did, have the effect of artificially inflating the market prices" of Belock securities (18a). Plaintiffs purchased Belock securities at these prices in reliance upon the false and misleading information (18a; 73a).

Section 10(b) and Rule 10b–5 prohibit false statements "in connection with the purchase or sale of any security." Both district judges below dismissed the complaints because

> the gravamen of defendants' activities [are not alleged] to be any wise "in connection with the purchase or sale of any security" as those words have been construed in their statutory setting. Whatever fraud is alleged here (it is in bare skeletal form) is directed against the government, notwithstanding its possible incidental

[3] Although actual knowledge and reason to know were alleged in the alternative, the court of appeals accepted this as an adequate allegation of the former (Pet. App. 8a–9a). See Fed. R. Civ. P. 8(e)(2).

> market impact. Furthermore, defendants or persons associated with them did not participate in the security transactions involved [Pet. App. 2c].[4]

The court of appeals reversed on the ground that the district judges had read the "in connection with" phrase of Section 10(b) and Rule 10b–5 too restrictively, stating that

> [i]t is reasonable to assume that investors may very well rely on the material contained in false corporate financial statements which have been disseminated in the market place, and in so relying may subsequently purchase securities of the corporation. * * * [Pet. App. 7a.]

Referring to its recent en banc decision in *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833,[5] the court held that the "in connection with" requirement was satisfied "whenever a device was employed 'of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities' * * *" (Pet. App. 6a–7a). The court of appeals added that "[t]here is no

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[4] This language of the first district judge was adopted by the second, who added that the complaint before him was "devoid of the statement of any facts that the fraud complained of was perpetrated by the defendants 'in connection with any purchase or sale'" of securities (Pet. App. 8b).

[5] Two of the individual defendants in that case have petitioned the Court for certiorari. *Coates* v. *Securities and Exchange Commission*, No. 897, this Term; *Kline* v. *Securities and Exchange Commission*, No. 937, this Term. The Commission has filed briefs in opposition to both petitions. Neither petition raises the "in connection with" issue. Although the issue is posed in that case by the court of appeals' decision with respect to the issuance of a corporate press release, the corporation has not petitioned for certiorari.

necessity for contemporaneous trading in securities by insiders or by the corporation itself" (Pet. App. 7a). It also stated that

> [t]he "ulterior motive" present in the instant case—the concealment of the fraud from the government—is irrelevant, since the false information was circulated to a large segment of the investing public. It is impossible to isolate the particular "fraudulent" acts and consider them as directed toward the government alone [Pet. App. 7a].

Finally, the court of appeals deferred any consideration of the issue of damages until after the facts had been fully developed in the trial of the cases (Pet. App. 15a & n. 8).

DISCUSSION

Petitioners' basic contention is that, because they did not trade in Belock's securities or primarily seek to deceive investors, they have not violated Section 10(b) and Rule 10b–5. Consequently this petition poses the question whether in these circumstances the securities laws prohibit a corporation whose securities are traded in the markets, and its officials, from disseminating information about its affairs that is known by them to be false and is reasonably likely to influence the investing public.

The quality of corporate information made available to the investing public and the authority of the Commission and the courts to police much of the information upon which investment decisions are based turn in large part on the answer to this question. This case involves both corporate reports that were filed

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with the Commission and other public statements that were not. Filed public statements by corporations are subject to other provisions of the Act in addition to Section 10(b). If there were circumstances in which unfiled public statements by corporations were immune from the securities laws and the Commission's rules implementing those laws, there would be a large gap in the "reasonably complete and effective"[6] statutory framework established by Congress for the protection of the investing public.[7]

The question presented by this petition arises from the dismissal of the complaints in the district court,

[6] Section 2 of the Act, 15 U.S.C. 78b.

[7] Petitioners do not attempt to distinguish between the power of the Commission to deal with unfiled public statements by corporations and the right of investors injured by a violation of the statute and rule to sue to recover their damages (*e.g.*, Pet. 13). This Court has already held that a private right of action exists under the proxy provisions of the Act. *J. I. Case Co.* v. *Borak*, 377 U.S. 426. Although it has never expressly decided whether a private right of action is similarly implied for violations of Section 10(b) and Rule 10b–5, it has upheld complaints claiming that right, without discussion of the question. *Surowitz* v. *Hilton Hotels Corp.*, 383 U.S. 363; *Tcherepnin* v. *Knight*, 389 U.S. 332; cf. *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 471, n. 4 (opinion of Mr. Justice Harlan). Every court of appeals that has considered the issue has held that this remedy exists. *E.g.*, *Janigan* v. *Taylor*, 344 F. 2d 781 (C.A. 1), certiorari denied, 382 U.S. 879; *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 (C.A. 2); *McClure* v. *Borne Chemical Co.*, 292 F. 2d 824 (C.A. 3), certiorari denied, 368 U.S. 939; *Beury* v. *Beury*, 222 F. 2d 464 (C.A. 4); *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5), certiorari denied, 365 U.S. 814; *Texas Continental Life Ins. Co.* v. *Dunne*, 307 F. 2d 242 (C.A. 6); *Jordan Bldg. Corp.* v. *Doyle, O'Connor & Co.*, 401 F. 2d 47 (C.A. 7); *Myzel* v. *Fields*, 386 F. 2d 718 (C.A. 8), certiorari denied, 390 U.S. 951; *Ellis* v. *Carter*, 291 F. 2d 270 (C.A. 9), dismissal affirmed, 328 F. 2d 573 (C.A. 9); *Stevens* v. *Vowell*, 343 F. 2d 374 (C.A. 10).

and thus does not involve the troublesome problems that might arise upon trial. For the reasons stated below, it is our view that the court of appeals properly held that a claim is stated under Section 10(b) and Rule 10b–5. Since no other court of appeals has ruled upon the question,[8] and since the decision below is correct, further review by this Court is not required.

1. Transactions in widely held securities are continually taking place in the markets. In giving effect to the purpose of the Act "to insure the maintenance of [these markets as] fair and honest, * * *"[9] Congress recognized that it was essential to provide the investing public with complete and accurate information about securities and their issuers. Thus, in reporting favorably on the Act, the House committee stated:

> The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of impor-

[8] The question has also been posed in the petition for certiorari in *Great American Industries, Inc.* v. *Securities and Exchange Commission*, No. 1195, this Term, although the corporate statements published in that case were related to securities transactions by the defendant corporation. The Commission will point out in its opposition to that petition that the broad "in connection with" question posed here is not necessarily involved in that case.

[9] Section 2 of the Act, 15 U.S.C. 78b.

tant information obstructs the operation of the markets as indices of real value. *There cannot be honest markets without honest publicity* * * *. [H. Rep. No. 1383, 73d Cong., 2d Sess. (1934), p. 11 (emphasis added).] [10]

Congress dealt with this problem in part by providing in Sections 13 and 15(d) of the Act, 15 U.S.C. 78m, 78o(d), for periodical and other reports by widely held corporations, and the Commission has established a detailed reporting system under these provisions.[11] These reports, some of which are involved here, are placed in the Commission's public files for the very purpose of being available for use by investors in their own securities transactions. It is, of course, implicit in the reporting requirements that the documents filed with the Commission must be complete and accurate.[12]

Although this reporting system establishes a permanent record of the most important information about the subject corporations and a framework within which other information can be assessed, the reports necessarily are only a small part of the information that corporations make available to the investing public about their affairs. The nature and timing of

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[10] Cf. S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), p. 68.

[11] See Rules 13a–1 to 13b–1, 15d–1 to 15d–21, 17 CFR, 240.13a–1 to 240.13b–1, 240.15d–1 to 240.15d–21.

[12] *E.g.*, *Ambrosia Minerals, Inc.*, 39 S.E.C. 734–735 n. 1; *Eureka Co.*, 38 S.E.C. 475, 476 n. 2; *Great Sweet Grass Oils, Ltd.*, 37 S.E.C. 683, 684 n. 1, affirmed *per curiam*, 256 F. 2d 893 (C.A. D.C.). Suits have been brought by the Commission to compel the filing of reports that are accurate and in conformity with its regulations. 2 Loss, *Securities Regulation* (2d ed. 1961), pp. 846–847 & n. 208.

the reporting system limit its effectiveness for the desirable rapid and widespread dissemination of material information to the investing public. Therefore, corporations commonly make the initial announcements of important developments in press releases and other informal statements. And, if information contained in a filed report has not been disclosed previously, a press release is often issued in conjunction with the filing. It would probably not be feasible to require corporations to file every public statement with the Commission.

Congress recognized that the reporting system would not be sufficient to rid the markets of false information about securities. Accordingly, it gave the Commission power to suspend trading in securities, both on the exchanges and in the over-the-counter markets.[13] Such suspensions are designed "to prevent fraud" by immediate action "when fraudulent or manipulative practices of the issuer or other persons have deprived * * * [a] security of a fair and orderly market, or when some corporate event has made informed trading impossible and has created conditions in which investors are likely to be deceived." S. Rep. No. 379, 88th Cong., 1st Sess. (1963), pp. 26, 66. The suspension device was intended, however, to serve

[13] Sections 15(c)(5) and 19(a)(4) of the Act, 15 U.S.C. 78o(c)(5), 78s(a)(4). The Commission suspended trading in Belock securities when it first learned of the overcharges, "which will have a material adverse effect on the financial condition of the company as well as on its published prior earnings reports" and later lifted the trading ban "in view of * * * [subsequent filings and other] disclosures by the company." Securities Exchange Act Release No. 7632 (June 22, 1965), No. 7741 (Nov. 4, 1965).

only as a stop-gap measure to afford a breathing period until adequate disclosures could be made; Congress did not want the Commission to keep suspensions of trading in effect indefinitely.[14] There would, however, be no other way to protect the public in such situations unless, as the court below correctly held, Section 10(b) and Rule 10b–5 are generally applicable to corporate statements reasonably likely to affect the market.[15]

2. The legislative history indicates that Section 10(b) was intended to be as broad as the Act itself. Congress recognized that the various existing abuses in the securities markets were "all a single seamless web," [16] and that the various provisions of the Act designed to deal with particular abuses would have to complement each other. As the House committee stated, "No one of these evils can be isolated for cure of itself alone." [17] Thus, Congress could not have intended to give the Commission power to enforce the reporting requirements but not to police other corporate statements covering the same subject matter with an equal or greater impact upon the investing public and upon the securities markets.

Section 10(b) was intended to achieve the overall congressional objective by filling any gaps left by the specific provisions. In describing the section (as orig-

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[14] S. Rep. No. 379, 88th Cong., 1st Sess. (1963), pp. 25–26, 66–67.

[15] The relationship between the suspension power and the antifraud provisions is demonstrated by *Securities and Exchange Commission* v. *Electrogen Industries, Inc.*, CCH Fed. Sec. L. Rep. ¶92,156 (E.D. N.Y., Feb. 26, 1968).

[16] H. Rep. No. 1383, 73d Cong., 2d Sess. (1934), p. 6.

[17] *Ibid.*

inally introduced) before the House committee, Thomas G. Corcoran, one of the draftsmen of the Act, noted that it provided in effect, "Thou shalt not devise any other cunning devices." [18] Representatives of the securities industry complained that this provision would give the Commission power to prohibit virtually anything,[19] and the House then attempted to limit it.[20] In conference, however, the Senate version, which then gave the Commission rule-making power to prohibit "any manipulative or deceptive device or contrivance," S. 3420, § 10(b), 73d Cong., 2d Sess. (1934), was accepted by the House.[21] That version was enacted.

Petitioners argue that the "in connection with" phrase severely limits the application of the statute and rule; they read that phrase to require securities transactions by the corporation or its officials or a conscious purpose to affect securities transactions by others (Pet. 13–16).

Although we have found no specific legislative history indicating the reason for the inclusion of the "in connection with" phrase, it seems apparent that, in the absence of such a phrase, Section 10(b) would be universally applicable: it would authorize the Commis-

[18] *Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and 8720*, 73d Cong., 2d Sess. (1934), p. 115.

[19] *Id.* at 178, 208–209, 251, 258, 297, 305; *Hearings Before the Senate Committee on Banking and Currency on S. Res. 84* (72d Cong.) *and S. Res. 56 and 97* (73d Cong.), 73d Cong., 1st and 2d Sess. (1933–1934), pp. 6624, 6634, 6899, 6910, 6936–6938, 6988.

[20] See H.R. 9323, § 9, 73d Cong., 2d Sess. (1934).

[21] See H. Rep. No. 1838, 73d Cong., 2d Sess. (1934), pp. 32–33.

sion to promulgate rules and regulations prohibiting all kinds of manipulative or deceptive devices regardless of whether any securities transactions were affected. Since Congress did not intend the Act to be applicable to situations bearing no relation to securities transactions, it was necessary to insert some such limiting language in Section 10(b). If Congress had sought to do more than this by withdrawing the protection of Section 10(b) when there is no corporate trading or purpose to injure investors, it could have used the phrase "*in* the offer or sale of any securities" or the phrase "*for the purpose of* inducing the purchase or sale of such security," as it did in other provisions of the securities acts.[22] But to read these restrictive phrases into the much broader language actually used in Section 10(b) would be contrary to the teaching of this Court that federal securities legislation, "'enacted for the purpose of avoiding frauds,' [should be construed] not technically and restrictively, but flexibly to effectuate its remedial purposes." *Securities and Exchange Commission* v. *Capital Gains Bureau,* 375 U.S. 180, 195 (footnote omitted); *Tcherepnin* v. *Knight, supra,* 389 U.S. at 336.

Nor is avoidance of overlap with other provisions of the securities laws any reason why Section 10(b) should be narrowly construed. As this Court recently pointed out in *Securities and Exchange Commission v. National Securities, Inc., supra,* "The fact that there may well be some overlap is neither unusual

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[22] Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q (a); Section 9(a)(4) of the Securities Exchange Act of 1934, 15 U.S.C. 78i(a)(4) (emphasis added in both).

nor unfortunate." 393 U.S. at 468. And cf. *J. I. Case Co.* v. *Borak, supra,* where the allegedly false proxy statement, like the corporate reports in this case, had been filed with the Commission and was thus also subject to Section 18(a) of the Act, 15 U.S.C. 78r(a).

3. Petitioners also argue that the decision below will transform any significant case of corporate misconduct or mismanagement into a violation of the federal securities laws because, whether or not the appropriate corporate officials are aware of the situation, the corporation's financial statements will be false or misleading if they fail to disclose the misconduct or mismanagement (Pet. 11–13, 17). It is not necessary in this case, however, for the Court to consider the broad issue framed by petitioner's argument. The financial statements in this case contained affirmatively false figures and other representations with respect to the amounts due Belock from the government and Belock's liability for renegotiation, and the complaints allege that the defendants knew that the information that they were disseminating was false (see p. 3, *supra*). It is only this factual situation that is presented by the petition.

4. Finally, petitioners contend that the decision below will expose publicly owned corporations and their officials to very large monetary liabilities (Pet. 17–19). The court of appeals recognized, however, that it might be appropriate to apply special rules of damages to situations such as this; at the suggestion of the Commission, which was participating *amicus curiae,* it determined not to resolve the difficult and complex question of damages on the basis

of the bare allegations of the complaint (Pet. App. 15a & n. 8). We do not believe that this Court should attempt to deal with this issue before the courts below have had an opportunity to do so.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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